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Understanding Based Alternative to “Plain Paper Prohibitation”

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An Understanding Based Alternative to "Plain Paper Prohibitation"

By Louis G. Gutberlet, CPA

It has been twelve years since the members of the Accounting and Review Services Committee (ARSC), including myself, concluded that practitioners should always issue a report when "submitting" less than audited financial statements of a privately owned entity. A lot has transpired since then. We have plain paper prospective financials. We have uncompiled personal financials. And we have concerned members who believe that there are still "undefined services."

In that connection, on September 7, 1989, ARSC held a public hearing. The objective of which was to discuss the possibility of amending Statements on Standards for Accounting and Review Services (SSARS) for a proposed "elective new service." This proposal is described by some as "less than a compilation" and by others as "reflecting a client's needs." The Private Companies Practice Section considers the proposal to be a solution, in part at least, to a significant practice problem.

As proposed, this service would allow practitioners to prepare and "submit" interim financial statements without reporting on them. The financial statements would include legend notations that there may be departures from generally accepted accounting principles (GAAP) or some other comprehensive basis of accounting (OCBOA), other than the omission of disclosures. This new service would be "elective" for interim financial statements and the information would be for "management's internal use" only.

On September 15th, 1989, the American Institute of CPAs (AICPA) issued a press release stating the SSARS would "not be amended to provide for different standards in connection with interim financial statements." Based on discussions at the hearing, ARSC determined that amending the current standards "could lead to abuses" and a "lowering of the quality" of a practitioner's work.

The issue underlying this proposal has been debated by ARSC several times. While the idea has various forms, the substance is the same - should ARSC establish a service consisting of preparing and "submitting" financial statements of a privately owned entity without reporting on them (i.e., the "plain paper prohibitation" issue).

ARSC discussed this issue extensively before, during, and after the issuance of SSARS No. 1, *Compilation and Review of Financial Statements.* ARSC concluded that practitioners should always issue a report when "submitting" less than audited financial statements of a privately owned entity. ARSC intentionally set the standards to include interim and year-end financial statements: regardless of whether computer generated or manually prepared. The standards are applicable to all types of privately owned entities. ARSC also established minimum performance standards applicable to the compilation or review of financial statements.

In September of 1985, ARSC considered a draft proposal entitled *Financial Statements for Clients' Limited Use.* This proposal would have permitted practitioners to prepare (or assist in preparing) and "submit" financial statements intended for "management use only" without complying with the minimum standards for a compilation engagement. There was to be a written understanding stating the restrictions on the distribution of the financials and the practitioner's "did nothing" report.

The proposal specifically required adherence to the General Standards of the Profession, particularly due professional care. The proposal also required that if during the engagement anything came to the practitioner's attention that the financials would be used by a third party, then either the practitioner would have to comply, at a minimum, with SSARS No. 1 or withdraw.

The key to this proposal was the understanding. It required that there be a written understanding concerning the service and an understanding that the financial statements would be used solely by client personnel and not distributed to third parties for credit granting or other purposes.

Although some members of ARSC were sympathetic to the idea of an "internal use" or "plain paper" service, they generally believed it was not operational. Accordingly, ARSC never exposed the draft for the profession's consideration and comments.

In 1986, ARSC did approve an elective service not defined in previous SSARS. This service was for personal financial statements. That is, personal financial statements included in written personal financial plans. The standards require a written report.

The standards for such a service are:

a. A practitioner should establish an understanding with the client, preferably in writing, that the financial statements -
   i. Will be used solely to help the client and the client's advisors to develop personal financial goals and objectives.
   ii. Will not be used to obtain credit or for any purposes other than developing goals and objectives.
b. Nothing comes to the practitioner's attention that would cause the practitioner to believe that the financial statements will be used to obtain credit or for any purposes other than developing the client's goals and objectives.

ARSC adopted this elective service because personal financial statements included in such plans are "only incidental." On the other hand, stand alone financial statements may be the only information third party users receive. This last assertion by ARSC may or may not be accurate.

A Personal Perspective

Many perspectives on these proceedings are influenced by the outcome; not the process itself. After studying the transcript of the public hearing entitled *Proposed Level of Service Below a Compilation,* reading the various drafts, and having (in prior years) participated directly in standards setting, I offer the following perspectives on specific observations.

> **Exhibit I**
>
> *Example of a report when using the election provided by SSARS No. 6.*
>
> The accompanying Statement of Financial Condition of X, as of December 31, 19XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain other departures from generally accepted accounting principles and should not be used to obtain credit or for any purposes other than developing your financial plan. We have not audited, reviewed, or compiled the statement.

First, various individuals keep referring to plain paper services as "less than a compilation." The same techniques are used (successfully) on the "standards overload" issue. Big GAAP - Little GAAP. Second class citizens. Big-Eight (Giant-Six) vs. local firms. Nonsense. Standards are not more or less; they are just different. Different under different circumstances and intended to meet different needs of different users of information.

We have all heard the old cliche "We know the right answer, now we just need to ask the right questions." By appealing to the fears and prejudices that we all possess it is simple to get the right answer. For example, "Won't this proposal expose us to additional legal liability?" "Won't this proposal amount to an endorsement of less than professional service-bureau practices?"

Finally, ask yourself "Did ARSC consider all the alternatives?" Probably not. Who has heard or seen any discussion of the concept underlying SSARS No. 3 *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* or the idea of writing standards based on the understanding between a client and the practitioner?

Association with Financial Statements

Statement on Auditing Standards No. 26 defines association with financial statements somewhat as follows:

> Practitioners are associated with financial statements when consenting to the use of their name in a report or written communication containing financial statements. In addition, when practitioners submit financial statements to a client or others that they have prepared or helped in preparing, they are associated with them even if they do not append their name to the financial statements.

Notice that the definition itself contains a solution to the debate. It states that even if practitioners do not append their name to financial statements, the practitioner is associated with them. Therefore, association does not mean that a practitioner must report. Others (ARSC) have imposed that requirement and they can change it. Not to deny or avoid association, but to report when it is appropriate or necessary under the terms and objectives of the engagement.

While deliberating SSARS No. 1, ARSC decided not to address the "concept of association: and its implications. It concluded that, for privately owned entities, most users are well aware of the relationship between clients and practitioners. Because of this knowledge, users automatically associate (in the dictionary sense of the word) the practitioner with a client's financial statements.

Accordingly, ARSC decided that it was more logical to address the practitioner's relationship to financial statements by:

a. Describing the nature of the services rendered.
b. Relating the services to the degree of responsibility assumed with respect to the financials.

Therefore, ARSC set forth a basic reporting framework by developing a "submission test." ARSC did not define "submission." Rather, it stated that anytime a practitioner "submits" less than audited financial statements of a privately owned entity to a client or others, the practitioner should comply with the standards for a compilation or a review. A compilation is the lowest defined level of service when "submitting" financial statements. A practitioner's reporting responsibilities when "submitting" such financial statements are summarized in Exhibit II.

Just what constitutes the "submission" of financial statements to a client or others resulting in the requirement that a practitioner comply with the provisions of SSARS No. 1? A recent ARSC interpretation defines "submission" along these lines. Submission is transmitting financial statements to a client or others that a practitioner has:

a. prepared, either manually or through the use of computer software, or
b. modified by materially changing account classifications, amounts, or disclosures directly on client-prepared financial statements.

ARSC goes on to identify circum-

Exhibit II

Privately Owned Entity Submission Standards

Submission Test

Anytime a practitioner "submits" less than audited financial statements of a privately owned entity to his or her client or others, the practitioner should comply with the standards for a compilation or a review.

Plain Paper Prohibitation

Anytime a practitioner "completes" a compilation or a review of the financial statements of a privately owned entity, an appropriate report under the provisions of SSARS should accompany the financial statements submitted to the client or others.

This precludes the practitioner from merely typing or reproducing financial statements as an accommodation to the client.

Minimum Level of Service

When a practitioner is involved with the financial statements of a privately owned entity, the "minimum" level of service he or she may provide and report on is a compilation.

Pecking Order

When a practitioner renders a compilation service in connection with financial statements that he or she also reviews, the practitioner should issue a review report under the appropriate provisions of SSARS.

When a practitioner renders a compilation service in connection with financial statements that he or she also audits, the practitioner should issue an audit report under the appropriate provisions of generally accepted auditing standards.

stances that do not constitute a "submission" of financial statements as follows:

a. Reading client-prepared financial statements.
b. Proposing adjusting journal entries or disclosures to the financials, either orally or in written form, that materially change client-prepared financial statements, as long as the practitioner does not directly modify the client-prepared document.
c. Preparing standard monthly journal entries (i.e., standard entries for depreciation and expiration of prepaid expenses).
d. Providing a client with a financial statement format, that does not include dollar amounts, to be used by the client to prepare financial statements.
e. Advising a client about the selection or use of computer software that the client will use to prepare financial statements.
f. Providing the use of or access to computer hardware or software that the client will use to prepare financial statements.

That's all well and good. However, wouldn't it be more efficient if ARSC abandoned the "submission test" and address reporting responsibilities from the perspective of the terms and objectives of the engagement? Association in and of itself does not require a practitioner's report. For example, ARSC might determine that financials intended for third party use require a report. Whereas, financials intended for internal use do not require a report. That is, a report on "internal use only" financials could be elective.

And then there's SSARS No. 3. It allows a special form of standard compilation report when the prescribed form or related instructions call for a departure from GAAP or some OCBOA. The idea underlying this approach is that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the form. Accordingly, there is no requirement to advise the user of departures from GAAP or some OCBOA required by the form or related instructions.

The special compilation report contains the following third paragraph.

> These financial statements (including related disclosures) are presented in accordance with the requirements of (name of body) which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

Notice that there are no restrictions on the distribution of the information contained in the prescribed form. Notice also that a user is notified that the information is not designed for those who are not informed. All this from the idea that the information contained in the presentation is "sufficient to meet the needs of those who designed or adopted the presentation."

Suppose someone "transcribes" certain information (financial statement elements) from unissued financial statements or a trial balance to a clean sheet of paper. Is the SSARS' literature applicable? *NO!* Would the answer be any different if the information came from computer generated interim financials? No! Now, just because it looks like a duck and walks like a duck doesn't mean it's a duck! What if it is not an owner/manager's intent to present financial position and results of operations in accordance with GAAP or some OCBOA? But, the presentation is in the "form of financial statements." Does that make it a financial statement that must be in conformity or else? What is the owner/manager's intent?

What is meant by the term "form of financial statements?" What is a financial statement? SSARS defines a financial statement as "a presentation of financial data, including accompanying notes, derived from accounting records and *intended to communicate* an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles." What is the owner/manager's intent?

Remember, even if a practitioner participates in the preparation of financial statements, the information contained therein is the representation of the owner/manager. The fairness of a presentation in conformity with GAAP or some OCBOA is the owner/manager's prerogative and responsibility. What if the owner/manager does not intend that a presentation conform in the first place?

A Formal Proposal - Based on the Understanding

The understanding is the key. SSARS No. 1 is written from the viewpoint of "the objectives of the engagement." These objectives are the deciding factors. They should determine which procedures to use and which report, if any, to issue. Naturally, these objectives should be established when agreement is reached specifying the services that are to be rendered. The understanding should reflect the intent of the owner/manager. And of course, the understanding must consider the needs of the users of the information. However, we should not presume to know more than the issuer or the practitioner as to what those needs are. ARSC is not establishing accounting standards; they are writing standards for services to be rendered.

The services might include the presentation of financial information in the "form of financial statements." That does not necessarily mean that the information purports to be in conformity with GAAP or some OCBOA. What is the owner/manager's intent? Could a report be written (or a legend included) that makes that intent clear to any user of the information?

This proposal presumes that there are not restrictions on the distribution of the financial information. However, it makes no difference. It could be elective. It could be mandatory. But why should there be any restrictions?

Association does not require a report. Therefore, a practitioner may or may not choose to issue a report on the presentation. If the election not to report is exercised, a legend should be included simply because practitioners cannot avoid association.

Following are some standards, reflecting due professional care, that ARSC could establish that reflect an understanding based alternative to the "plain paper prohibitation" issue.

1. Establish an understanding with the client, preferably in writing, that the financial presentation (interim or year-end) resulting from the engagement is not intended to present financial position or the results of operations according to GAAP or some OCBOA. In addition, the practitioner will not issue a report on the engagement.
2. A report is not to be issued on such a financial presentation. However, a legend should be included on each page describing its nature and limitations. That is, that it does not purport to reflect financial position or the results of operations in accordance with GAAP or some OCBOA.
3. The practitioner's name is not to be disclosed anywhere on the financial information or on a report cover. If the information is included with a written communication (a transmittal letter, for example) a statement that the information is not intended to present financial position, results of operations, or cash flows should be communicated in writing.
4. This service should be conducted according to the General Standards of the Profession.
   a. Professional Competence.
   b. Due Professional Care.
   c. Planning and Supervision.
   d. Sufficient Relevant Data.

Example of a Legend

This financial information is not intended to present financial position or results of operations in accordance with generally accepted accounting principles. It does not purport to reflect all appropriate adjustments and disclosures and was not compiled, reviewed, or audited by our accountant.

If the profession believes that there should be restrictions on the distribution of such information: so be it. These standards can accommodate such thinking. And the supporters of "plain paper services" could endorse such an approach; whether reported upon or not.

For those in the profession who believe that there is nothing lower than a compilation, please see Exhibit III: An Understanding Based Alternative Compilation Report. This report reflects an understanding that the owner/manager does not intend that the information be in accordance with GAAP or some OCBOA.

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Exhibit III

Understanding Based Alternative Compilation Report

We have compiled the accompanying (interim) financial information of the ABC Company as of December 31, 19X1 and 19XX, and for the nine months then ended, in accordance with standards established by the American Institute of Certified Public Accountants.

Our compilation was limited to presenting certain owner/manager designated information from summary accounting records (maintained by (us) ABC Company personnel). We have not audited or reviewed the financial information referred to above, and accordingly, we do not express an opinion or any other form of assurance on it.

This presentation presumes that the information contained therein is sufficient to meet the needs of the owners (management) of the ABC Company. It is not intended to communicate the entity's financial position or results of operations in accordance with generally accepted accounting principles or any other comprehensive basis of accounting. Accordingly, this presentation is not intended for and does not include information that may be considered necessary for users outside the owners (management) of the ABC Company.